seriously considered if the Commission intends to conduct a rational cost-benefit analysis in this proceeding.[45] Given the increased risks of anticompetitive and anti-ratepayer abuses under the nonstructural regulations in the absence of structural separation, the structural separation requirement must be maintained.

Even apart from the inadequacies of the nonstructural regulations, there is another problem with structural integration that was never addressed in the Computer III Remand Order or in the Notice in this proceeding. In the Computer III Remand Order, the Commission preempted state structural separation requirements applicable to the intrastate portion of jurisdictionally mixed BOC enhanced services,[46] which was upheld in California

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[45] The Commission may believe that its reliance on its safeguards against cross-subsidies has been upheld in California III and is therefore a settled issue. In fact, however, just as ONA was approved in California I, 905 F.2d at 1233, but rejected in California III as a basis for structural relief, 39 F.3d at 929-30, the safeguards against cross-subsidies cannot automatically be assumed to constitute a rational basis for structural relief in a new cost-benefit balance in light of a new record. By its very nature, a cost-benefit analysis must consider all relevant factors on both sides of the balance. See Motor Vehicle Mfrs. Ass'n. v. State Farm Mut. Auto. Ins. Co., 463 U.S. 29 (1983); California I, 905 F.2d at 1230; Sierra Club v. Sigler, 695 F.2d 957, 978 (5th Cir. 1983); Rybachek v. United States EPA, 904 F.2d 1276, 1289 (9th Cir. 1990). If the Commission omits a relevant factor, a reviewing court will be forced to reverse, since the court "cannot guess at how the FCC would have balanced" all of the relevant factors. California I, 905 F.2d at 1238 n.29.

[46] 6 FCC Rcd at 7632-36, ¶¶ 122-29.

III.[47] Presumably, the Commission would readopt such preemption if it were to decide in this proceeding to eliminate structural separation again.

The problem with such preemption is that in the case of intrastate enhanced services, the Commission does not even pretend to substitute any other intrastate protections for the preempted rules. Except to the extent that it is able to preempt state regulation, this Commission has no authority over intrastate BOC cost allocations or intrastate access to BOC facilities. Thus, aside from the imposition of structural separation, the Commission cannot prevent cross-subsidies between BOC intrastate regulated services, including access services, and the BOCs' enhanced services or access discrimination by the BOCs against independent providers of local enhanced services. Structural separation, imposed uniformly at the federal and state levels through preemption, helps greatly to prevent these harms to the intrastate segment of the enhanced services market, but nonstructural regulation imposed only at the interstate level can have no impact on the intrastate segment of the market, which includes most alarm services and local voice messaging service providers.[48]

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[47] 39 F.3d at 931-33.

[48] It should also be noted that the scope of this problem is much broader than the category of purely intrastate enhanced services. For example, the service offered by a local voice messaging provider might enable its customer to receive an (continued...)

Thus, if the Commission eliminates the structural separation requirement, and continues to preempt state structural separation requirements, intrastate ratepayers and users of intrastate enhanced services will be deprived of the protection of structural separation, without any new or additional safeguards as a substitute. Since the Commission has no plans or intent to force all of the states to establish intrastate cost accounting, affiliate transaction and ONA-type regulatory controls as ostensible substitutes for structural separation, any decision to eliminate structural separation and to preempt any state regulation inconsistent with such elimination is totally unreasonable with regard to all intrastate enhanced services.[49] The Commission effectively would be creating a vacuum within which there might be little capability to control BOC provision of enhanced services effectively.[50]

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[48] (...continued)
interstate call, thus constituting an interstate service in that case, but the service provider will buy the access it needs out of the BOC's intrastate tariff, leaving it at the mercy of whatever protections are available at the state level.

[49] As in NARUC v. FCC, 533 F.2d 601, 616 (D.C. Cir. 1976), "the Commission not only intends to preempt state regulation ... but intends to issue no regulations of its own to govern these [intrastate] activities."

[50] The regulatory issue discussed here -- how BOCs' enhanced services should be structured -- should be distinguished from the issue of the intrastate regulatory status of enhanced services generally. These comments do not discuss or imply anything about the separate issue of whether enhanced services should be treated as regulated or nonregulated services by the states. The Commission has valid federal policy reasons for treating enhanced services as nonregulated and preempting any inconsistent state treatment. Such treatment by this Commission does not deprive
(continued...)

The preservation of competition in intrastate enhanced services has not been as high a priority for most state commissions as the maintenance of low rates for local service ratepayers. The BOCs thus have had a relatively free hand to subsidize their local enhanced services from their intrastate access service revenues and to discriminate against ESPs providing local services. The BOC anticompetitive activity discussed in the Computer III Remand proceeding and infra, has been directed largely against ESPs seeking intrastate access to the BOCs' networks. This gap in the Commission's proposed policy thus has had, and continues to have, real-world negative consequences for the enhanced services market and tips the balance even more strongly against the elimination of structural separation.

B. The Commission's Antidiscrimination Regulations and Other Factors Discussed in the Notice Are Not Sufficient to Control Discrimination and Other Anticompetitive Conduct by the BOCs

The Commission has never faced up to the implications of the MemoryCall Order and the rest of the massive record of anticompetitive abuses presented in the Computer III Remand proceeding. Except for the MemoryCall Order, the Commission ignored that record in the Computer III Remand Order. Its only

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50/ (...continued)
the states of techniques to safeguard against cross-subsidies and discrimination in the provision of intrastate BOC enhanced services by appropriate regulation of the BOCs' basic network services (e.g., cost allocation regulations, network unbundling and separate subsidiary requirements).

response to <u>MemoryCall</u> was that the conduct found in that case, including the "unhooking" of other ESPs' customers by BellSouth, would violate the Commission's CEI and ONA rules and that the implementation of ONA would prevent such problems in the future.[51/] BellSouth, in an <u>ex parte</u> filing concerning the BOC Waiver Petition, is even less realistic, asserting that its MemoryCall service "was deployed in full accordance with the FCC's requirements under an approved CEI plan" and that the access arrangements found to be discriminatory in the <u>MemoryCall Order</u> "were specifically authorized by the Commission's CEI rules and policies."[52/] BellSouth were correct, of course, the case against elimination of the structural separation requirement would be even stronger, since any access regime that permitted such brazen access discrimination could not possibly be permitted.

Not only was that explanation irrational in the <u>Computer III Remand Order</u>, but subsequent events also have only magnified the current relevance of the anticompetitive conduct found in the <u>MemoryCall Order</u> and reflected in the rest of the <u>Computer III Remand</u> record. First, the MemoryCall service was provided under a CEI plan that this Commission had found to comply with all of the CEI parameters, including equal access and price parity for

[51/] 6 FCC Rcd at 7623, n.211.

[52/] Letter from Ben G. Almond, BellSouth, to William F. Caton, Secretary, FCC, dated January 6, 1995, attachment, page 3, filed in this docket.

ESPs and BellSouth's own MemoryCall service.[53] Moreover, in approving the BellSouth CEI plan, the Bureau explicitly "prohibit[ed] BellSouth from using CPNI to identify particular customers of existing VMS competitors for 'targeted' marketing efforts."[54] The MemoryCall Order subsequently found, however, that BellSouth was doing just that.

The Commission never explained in the Computer III Remand Order why conduct that the Commission conceded would violate the CEI rules and that occurred under an approved CEI plan (see 6 FCC Rcd at 7623 n.211) did not demonstrate that the CEI rules were ineffective. Thus, the Commission's response to the MemoryCall Order, and, implicitly, to all of the anticompetitive conduct reflected in the Computer III Remand record occurring under approved CEI plans, was utterly irrational. Such anticompetitive conduct under approved CEI plans demonstrates that CEI, even in conjunction with all of the other antidiscrimination rules -- nondiscrimination reports, network information disclosure rules and customer proprietary network information rules -- is worthless as a substitute safeguard.

Now that California III has found that ONA will not add much to CEI and the other antidiscrimination rules, the Commission

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[53] BellSouth Plan for Comparably Efficient Interconnection for Voice Messaging Services, 3 FCC Rcd 7284, 7285-90 (CCB 1988).

[54] Id. at 7293.

must finally face up to the implications of MemoryCall and other evidence of abuses. Since ONA can no longer be considered a potentially significant additional factor, the protections against discrimination available to voice messaging providers and other ESPs are essentially the same as they were during the Computer III Remand proceeding. Those protections were insufficient to prevent a vast array of abuses documented in that docket, and there is no reason to believe that the same regulations can achieve any greater protection now.

Since the Commission ignored the 600-plus pages of record material submitted on this issue in the Computer III Remand proceeding, MCI is resubmitting that material in order to give the Commission an opportunity to assess the effectiveness of its antidiscrimination rules in light of all relevant factors. Attached as Exhibit A to these Comments are those portions of the briefs submitted in California III by MCI and the Newspaper Association of America discussing the record material on anticompetitive abuses.[55] The record material discussed and cited in those portions of the briefs will be made available in the ex parte submission. The Commission should not ignore this

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[55] Joint Brief of Petitioners MCI Telecommunications Corporation, in Case No. 92-70186, and Newspaper Association of America, in Case No. 92-70261, at 32-38 (April 21, 1993), and Reply Brief of Petitioners MCI Telecommunications Corporation, in Case No. 92-70186, and Newspaper Association of America, in Case No. 92-70261, at 10-17 (Sept. 8, 1993), People of the State of California v. FCC, No. 92-70083 and consolidated cases (9th Cir.).

material again.

The inadequacy of CEI/ONA to perform any more meaningful role now than it did when all of the previous discriminatory conduct was occurring is confirmed by two other documents being filed in this docket. The first, a report by Hatfield Associates, Inc., "ONA: A Promise Not Realized -- Reprise," submitted jointly by MCI, CompuServe and ITAA, details the lack of development of ONA in recent years and the BOCs' resistance to the type of unbundling necessary for the satisfactory development of enhanced services.

The second, an affidavit by Peter P. Guggina, Director of Technical Standards Management for MCI, attached hereto as Exhibit B, explains in detail why ONA, or any unbundling or other technical issue referred to the IILC, will never go anywhere. As Mr. Guggina explains, the IILC is essentially a black hole from which nothing ever emerges, or, if something does emerge, only years late and in a form that does not satisfy the competitive needs that necessitated the request to the IILC in the first place. The BOCs simply use the IILC to slow roll whatever request for network features is presented to it by a competitive service provider. In light of MCI's and other parties' experiences with the IILC over the past few years, any Commission policy decision that relies in part on the availability of the IILC to resolve requests by competitive service providers for BOC network features is inherently arbitrary. Thus, any decision based partly on the ONA process, which relies on the IILC, will be arbitrary.

The Hatfield Report also explains why the other proceedings mentioned in the <u>Notice</u> and the state of competition in enhanced services are irrelevant. The unbundling in the <u>Expanded Interconnection</u> proceeding is not the type of unbundling that is of any use to ESPs, and the <u>IN</u> proceeding has not resulted in any Commission actions. Ironically, as the Hatfield Report explains, the development of new technologies not only has failed to bring about more unbundling but has also made ESPs and other competitive service providers more vulnerable to abuses of the BOCs' monopoly power. The increasing complexity of the network resulting from the deployment of advanced technology makes it more feasible for the BOCs to use their control over signalling to discriminate against competitors in various ways described and documented in the Hatfield Report. Furthermore, enhanced services competition also makes that market more vulnerable to abuse by the monopoly BOCs. Enhanced services competition does nothing to loosen the BOC bottleneck in local exchange service. Finally, the Hatfield Report explains why fully separate subsidiaries more effectively protect against cross-subsidies and discrimination than do nonstructural regulations.

If there were any doubts about the BOCs' continuing monopoly power in local exchange service and their propensities to abuse that power in adjacent competitive markets, the history of discrimination and other anticompetitive conduct since the Computer III Remand proceeding should erase any such doubts. In addition to the run-around to which MCI and others have been subjected in their pursuit of unbundled network features, as detailed in the Guggina Affidavit, and the abuses described in the ATSI letter, the following is a typical sample of BOC anticompetitive abuses:

- Attached hereto as Exhibit C is a letter from the Missouri Telemessaging Association to members of the Missouri Senate, dated March 30, 1992, discussing incidents of "unhooking" and other unfair marketing practices by Southwestern Bell and US West directed against voice messaging service providers and the competitive disadvantages arising from the unavailability of BOC network features needed by voice messaging providers. This letter confirms the accounts of similar abuses contained in the December 13, 1994 ATSI filing.

- Notwithstanding previously issued Industry Carrier Compatibility Forum (ICCF) guidelines concerning central office code assignment policies, to which New York Telephone Company had agreed, Teleport Communications Group (TCG) and MFS Communications Company, Inc. (MFS) were forced to complain to the New York State Department of Public Service Commission about New York Telephone's failure to assign central office codes to them for use in offering competitive local exchange service. New York Telephone was ordered to make central office codes available to TCG and MFS in a non-discriminatory manner in accordance with the ICCF guidelines.[56]

- In spite of prior opinions of the New York PSC ordering intraLATA equal access, New York Telephone Company initially rejected MCI's request for such access as

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[56] Proceeding on Motion of the Commission to Investigate Performance - Based Incentive Regulatory Plans for New York Telephone, Case 92-C-0665 (NYPSC Oct. 4, 1993), attached as Appendix __ to MCI's ex parte submission.

"premature" and not a "bona fide request," since New York Telephone had not yet filed the necessary tariff. The PSC had to intervene to instruct New York Telephone to provide intraLATA access in response to MCI's request as required by PSC order.[57/]

- Earlier this year, this Commission found Ameritech's NPA "overlay" plan for the Chicago metropolitan area to be unreasonably discriminatory against competing paging and cellular carriers and unreasonably preferential to wireline carriers, especially Ameritech itself, in violation of Section 202(a) of the Communications Act, as well as an unreasonably "selective and asymmetric treatment of carriers in the administration of telephone number resources," in violation of Section 201(b) of the Act.[58/]

- In early 1993, Southern Bell proposed an expanded area local service plan in South Carolina, which had the effect of converting what would have been intraLATA toll calls into local calls, charged at rates below the access charges that MCI and other IXCs have to pay to offer competitive intraLATA toll service. Independent LECs thereafter filed similar expanded area local service plans. MCI and other IXCs appealed the South Carolina Public Service Commission's approval of the plan, the implementation of which was stayed on the grounds that it would hinder the development of competition in the intraLATA market.[59/] While the case was on appeal, it was discovered in another case that Southern Bell and other LECs had entered into a secret agreement regarding the rates they would pay each other for terminating expanded local area calls originated in another LEC's service area. The secret rates were less than the tariffed access rates MCI and other IXCs have

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[57/] See letter from Richard C. Fipphen, MCI, to Joseph A. Post, New York Telephone Co., dated May 20, 1994; letter from Joseph A. Post to Richard C. Fipphen, dated June 9, 1994; letter from Richard Stannard, Director, Communications Division, New York State Public Service Commission, dated July 5, 1994, attached to MCI's ex parte submission as Appendix .

[58/] Proposed 708 Relief Plan and 630 Numbering Plan Area Code by Ameritech - Illinois, IAD File No. 94-102, FCC 95-19 (released Jan. 23, 1995).

[59/] Order Granting Stay, AT&T Communications of the Southern States, Inc., et al. v. BellSouth Telecommunications, Inc., CA No. 93-CP-40-4184 (S. Car. Circuit Court Nov. 11, 1993), attached as Appendix to MCI's ex parte submission.

to pay to terminate the same calls. In discovery, on cross-examination at a hearing, Southern Bell misrepresented the terminating rates the LECs were paying one another. Once the secret agreement became known, Southern Bell initially refused to offer similar terms to MCI and other IXCs.

- Despite Ameritech's hype for its mislabelled "Customer First Plan" filed at the Illinois Commerce Commission (ICC), and ostensible willingness to face competition, "its true response to competition," in the words of the ICC staff, has been to "fight it every inch of the way until ordered to permit it."[60/] Earlier this year, the ICC, in response to a complaint brought by MFS Intelenet of Illinois, Inc., ruled that Illinois Bell had discriminated unreasonably against MFS by failing to offer MFS inter-carrier arrangements similar to those offered to independent telephone companies and required Illinois Bell to enter immediately into such an arrangement.[61/]

- MCI, notwithstanding its prior authorization to provide local exchange services, was forced to bring a similar complaint seeking the same interim relief, which is still pending. The complaint alleges that Illinois Bell has been willing to provide MCI only with end user services in response to MCI's requests for interconnections that would enable it to provide competitive local exchange service.[62/] Ironically, in response to the application submitted by MCI Metro Access Transmission Services, Inc. (MCI Metro) for authority to operate as a competitive exchange carrier in Illinois' "Market Service Area 1," Illinois Bell has taken the position that such service should be marketed separately from MCI's interLATA services and that MCI

60/ Reply of the Staff of the Illinois Commerce Commission to Brief on Exceptions to the Hearing Examiner's Proposed Order at 1, MFS Intelenet of Illinois, Inc. v. Illinois Bell Telephone Co., No. 94-0422 (Ill. Comm. Comm'n Jan. 6, 1995), attached as Appendix to MCI's *ex parte* submission.

61/ Interim Order, MFS Intelenet of Illinois, Inc. v. Illinois Bell Telephone Co., No. 94-0422 (Ill. Com. Com'n. Jan. 25, 1995), attached to MCI's *ex parte* submission as Appendix .

62/ Complaint and Petition Requesting Expedited Relief of MCI Telecommunications Corporation, MCI Telecommunications Corporation v. Illinois Bell Telephone Co., No. 94-0483 (Ill. Com. Com'n. Nov. 22, 1994), attached to MCI's *ex parte* submission as Appendix .

and MCI Metro should deal with each other on an arm's length basis, in spite of MCI's and MCI Metro's zero market share in local exchange services.[63]

- The Michigan Public Service Commission found that Michigan Bell improperly won a competitive bid for an interactive video service by pricing below its long-run incremental costs and by failing to include all appropriate related costs in its bid. The PSC held that such below-cost pricing must be assumed to have been subsidized from Michigan Bell's basic local exchange and access rates and that these violations constituted illegal anticompetitive activities.[64]

- In 1993, Pacific Bell secretly manipulated the California Public Utilities Commission (CPUC) intraLATA toll competition proceeding through unreported ex parte contacts with the CPUC that resulted in the significant weakening of consumer and competitive safeguards in the decision authorizing intraLATA toll competition. After Pacific Bell's ex parte manipulation was revealed, the decision was withdrawn, thus delaying intraLATA toll competition, to Pacific Bell's advantage.[65]

- Pacific Bell refuses to allow its Centrex customers to route intraLATA calls to competing toll carriers without dialing extra digits.[66]

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[63] See Testimony of Richard Kolb, MCI Metro Access Transmission Services, Inc., Docket No. 94-0400 (Ill. Com. Com'n. Jan. 17, 1995), attached as Appendix to MCI's ex parte submission.

[64] City Signal, Inc. v. Michigan Bell Telephone Co., Case No. U-10225 (Mich. PSC May 21, 1993), attached as Appendix to MCI's ex parte submission.

[65] Order Rescinding Decision 93-09-076, Alternative Regulatory Frameworks for Local Exchange Carriers, I.87-11-033, Decision 93-10-033 (CPUC Oct. 6, 1993), attached as Appendix to MCI's ex parte submission; California Public Utilities Commission, General Counsel, "A Report to the Commission: A Review of the Events Surrounding D. 93-09-076 (IRD)" (Oct. 13, 1993).

[66] Closing Brief of MCI Telecommunications Corporation Re Motion for Immediate Issuance of Sua Sponte Relief, Ex Parte Order or Preliminary Injunction, MCI Telecommunications Corporation (U 5001 C) v. Pacific Bell (U 1001 C), Case No. 94-12-032 (CPUC Feb. 3, 1995), attached as Appendix to MCI's ex parte submission. See also A Crack in the Monopoly, The Sacramento Bee, Jan. 12, 1995, at 20.

- In 1993, the CPUC ordered Pacific Bell to pay a refund of $35 million and a $15 million penalty on account of its practice of charging its customers improper late-payment fees.[67]

- In 1993, after a civil antitrust jury trial, Southwestern Bell was found liable in the amount of over $15 million in damages to two competitive telephone directory publishers for having wrongfully denied access to its subscriber listing information and was enjoined to provide such information at specified rates to all independent publishers, including plaintiffs.[68] In the same month, a competitive service provider, Metro-Link Telecom Inc., was awarded $5.7 million in damages in another civil antitrust action against Southwestern Bell's operating subsidiary, SBC Communications Inc. SBC had tried to drive out Metro-Link by removing Metro-Link numbers from its telephone directories and refusing to assign it any new numbers.[69] Directory data seems to be a problem area for Southwestern Bell, which is the only RBOC that refuses to provide access to its directory database to other service providers.

- Southwestern Bell has been involved in two bribery scandals involving the Oklahoma Corporation Commission (OCC). In one, OCC Commissioner Bob Hopkins and a Southwestern Bell lobbyist were recently convicted in federal court of bribery. The lobbyist had bribed Hopkins to vote favorably on Southwestern Bell's request to apply $50 million in overearnings to network modernization, rather than refunding that amount to ratepayers.[70] The other involved Southwestern Bell's attempt to gain generally favorable treatment from OCC

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[67] Toward Utility Rate Normalization, Inc. v. Pacific Bell (U 1001 C), Case 91-03-006, Decision 93-05-062 (CPUC May 26, 1993), attached as Appendix   to MCI's ex parte submission.

[68] Final Judgment, Great Western Directories Inc. and Canyon Directories, Inc. v. Southwestern Bell Corporation, et al., C.A. No. 2:88-CV-0218-J (N.D. Tex. July 2, 1993), appeal docketed, No. 93-1715 (5th Cir. Jan. 7, 1994), attached as Appendix   to MCI's ex parte submission.

[69] Mark Lewyn, How to Vault the Final Hurdle to Telecom Reform, Business Week, March 20, 1995, at 5, attached as Appendix   to MCI's ex parte submission.

[70] See Ex-Regulator, Lawyer Guilty in Bribe Case, The Daily Oklahoman, Dec. 1, 1994, at 1,2, attached as Appendix   to MCI's ex parte submission.

Commissioner Bob Anthony, which failed when Anthony went to the FBI after being approached by Southwestern Bell.[71]

- Southern Bell has had to settle certain proceedings arising from anticonsumer activities. In 1992, Southern Bell and the State of Florida settled a grand jury investigation of Southern Bell's sales and repair activities, including allegations that customer repair and maintenance records had been falsified and that customers had been billed for services they never ordered. The settlement required Southern Bell to refund $16.6 million to its customers.[72]

In short, monopoly is as monopoly does. As competition develops in markets adjacent to the BOCs' monopoly local exchange services, the BOCs can be counted on to fight an increasingly desperate rear-guard action to delay the loosening of the local exchange bottleneck. Using a variety of strategies, they have leveraged their remaining monopoly power to extort whatever advantage they can secure in emerging adjacent competitive markets, including the enhanced services market. The blithe suggestion in the Notice that BOC nondiscrimination reports have shown that discrimination has not occurred therefore cannot be taken seriously.[73] The development of competition in the enhanced services and other markets therefore has done nothing, and can do nothing, to diminish the threat of anticompetitive abuses. If anything, the vigor of competition in these other

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[71] See public statement of Commissioner Bob Anthony, Southernwestern Bell Cause No. PUD 260 (Okla. Corp. Com'n Oct. 2, 1992), attached as Appendix   to MCI's ex parte submission.

[72] Southern Bell 'Agrees' With Florida Prosecutor; Distributes $16.6 Million, Telephone News, Oct. 19, 1992, at 2-3.

[73] Further Demand Notice at ¶ 29.

services only increases the vulnerability of competitive service providers to the BOC abuses.

Since the Commission's antidiscrimination rules are no stronger than they were during the massive abuses reflected in the Computer III Remand record, and fundamental unbundling is now a dead letter, it can only be concluded that the BOCs will continue to discriminate against other ESPs in the provision of access, in marketing and in other ways. CEI, what remains of ONA and the other antidiscrimination rules -- which have not been significantly strengthened since Computer II, when they were found necessary structural separation[74/] therefore cannot be considered a rational substitute for structural separation. As the House Judiciary Committee observed last year with regard to the BOCs' anticompetitive conduct, "these experiences highlight the propensity of various RBOCs to exploit their monopoly power and indicate the continuing limitations of Federal and State regulatory capabilities."[75/]

[74/] See 47 C.F.R. §64.702(d)(2), (3). As the Commission previously stated, "[a]doption of structured separation in addition to these measures reflects our belief that these measures are not sufficient to answer fair competition," and thus cannot provide a bases for elimination of structured separation. Policy and Rules Concerning the Furnishing of Customer Premises Equipment, Enhanced Services and Cellular Communications Serivces by the Bell Operationg Cos., 95 FCC 2d1117, 1134 (1983), aff'd sub nom. Illinois Bell Tele. co. v. FCC, 740 F. 465 (7th Cir. 1984).

[75/] House Judiciary Committee, Antitrust and Communications Reform Act of 1994, H. Rep. No. 559, Part 2, 103d Cong., 2d Sess. 59 (1994) (Antitrust and Communications Report), also citing BOC violations of the MFJ. Id. at n.245.

Moreover, as illustrated by these examples, most of the discrimination and anticompetitive abuses against ESPs and other competitive service providers relates to intrastate enhanced and other services and intrastate access services used by ESPs and other service providers. Since the Commission proposes to do nothing to replace structural separation with regard to intrastate enhanced services, ESPs will continue to be exposed to most of the harms that they have experienced to date if structural separation is eliminated, irrespective of the effectiveness of nonstructural regulations for interstate enhanced services.

Given the BOCs' continuing anticompetitive conduct against ESPs under structural integration, the lack of development of ONA or any other unbundling scheme useful to ESPs and the defenselessness of voice messaging providers and other local ESPs against multi-state Regional Bell Holding Companies (RBHCs), it is clear that structural separation must be retained. That requirement makes it much more possible to deal effectively with a BOC's ability to manipulate the availability, installation, maintenance, repair and quality of network features and access services. By requiring a separate BOC enhanced service affiliate to acquire the BOC's access services on the same basis as competing ESPs, structural separation not only helps to ensure non-discriminatory access to the BOC's local exchange network, but it also promotes cost-based pricing.

By requiring separate marketing personnel, structural separation also inhibits unhooking and other types of misuse of customer information and improper tying of local exchange and enhanced services. The requirement of a separate affiliate also provides greater certainty that network information will be disclosed in a timely and non-discriminatory manner to all users. Moreover, structural separation makes it easier for employees working on the local exchange side of a BOC's business to deal with their fellow employees in the BOC's enhanced services business on an arm's length basis, the same as they would with any other customer, by physically separating the carrier's local exchange and enhanced services operations. By making transactions between different operations more visible, structural separation reduces the risk that anticompetitive arrangements between affiliates will go undetected.

C. The Cost Accounting Rules Do Not Prevent Cross-Subsidies

Although the Notice is silent on the other half of the nonstructural regulations -- the cost accounting rules -- their effectiveness must be considered in any rational cost-benefit analysis of a policy shift from structural separation to structural integration under nonstructural safeguards. Assuming, as must be the case, that the cost allocation rules and other accounting regulations are still part of the regulations being substituted for structural separation, they must be an element in the balance.

As in the case of discrimination and other anticompetitive conduct, much of the cost shifting that occurs in connection with the provision of BOC enhanced services relates to the intrastate aspects of the affected enhanced services. To the extent that BOC enhanced services are offered on an intrastate basis, the cost shifting and misallocation opportunities that are presented thereby will largely affect intrastate costs. At the same time, this Commission, which has removed the protection of structural separation, cannot provide any other regulatory protection against intrastate cross-subsidies.

One of the more egregious examples of such intrastate cross-subsidies was uncovered by a California PUC audit, which found that state ratepayers had subsidized Pacific Bell's development of its voice messaging and other enhanced services. Pacific Bell entered into a settlement of these issues with the CPUC requiring it to refund $57 million to customers and to reduce its rates by $19.1 million.[76/] In a related proceeding addressing Pacific Bell's application to transfer its enhanced services to a separate subsidiary, the CPUC required that ratepayers also be credited with the increase in value of the enhanced services

[76/] Application of Pacific Bell, a corporation, for authority to increase certain intrastate rates and charges applicable to telephone services furnished within the State of California, Application 85-01-034, Decision 92-07-076 (CPUC July 22, 1992), attached as Appendix to MCI's *ex parte* submission.

assets in the form of an additional one-time rate reduction.[77]

There have also been a series of federal and state audits that have uncovered a variety of cross subsidies and overcharges:

- Pacific Bell has continued to fund its enhanced services, as well as other competitive ventures, with ratepayer revenues. The CPUC permitted Pacific Telesis Group to spin off its wireless service operations to an independent company only on condition that Pacific's ratepayers be reimbursed $7.9 million for their funding of development costs.[78] Similar problems were revealed in a CPUC audit released last summer and in an audit of BellSouth released at the same time.[79] Previously, audit teams conducting combined FCC/state joint audits of the BOCs had complained that most of the BOCs had stalled the progress of the audits through slow responses to data requests and cited, in particular, BellSouth's "consistent pattern of obstructionist behavior."[80]

- A Common Carrier Bureau audit, released in October 1993, of the affiliate transactions between BellSouth's operating companies and a nonregulated subsidiary revealed overcharges by the affiliate of $25.7 million, resulting in overcharges to interstate ratepayers of $6 million.[81]

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[77] Pacific Bell Transfer, attached as Appendix   to MCI's *ex parte* submission.

[78] Interim Opinion, Investigation on the Commission's own motion into the Pacific Telesis Group's "spin-off" proposal, I. 93-02-028, Decision 93-11-011 (CPUC Nov. 3, 1993), mod. on other grounds, Decision 94-03-036 (CPUC March 9, 1994), attached as Appendix   to MCI's *ex parte* submission.

[79] Bell Audits Find Common Problems, NARUC Told, Telecommunications Reports, August 1, 1994, at 13.

[80] Joint Audits of SW Bell, Ameritech, Pacific Telesis Near End; Controversies Continue to Stall BellSouth, NYNEX Reviews, Telecommunications Reports, April 4, 1994, at 7-8.

[81] *See* BellSouth Affiliate Transaction Audit: Summary of Audit Findings and attached BellSouth Statement, BellSouth Corporation, BellSouth Telecommunications, Inc., AAD 93-127 (Nov. 8, 1993).

- A Common Carrier Bureau audit of transactions between the GTE Telephone Operating Companies (GTOCs) and two nonregulated affiliates revealed overcharges of the GTOCs by the affiliates, which were passed on by the GTOCs to their ratepayers. The GTOCs entered into a Consent Decree requiring a common line rate reduction of $49.5 million.[82/]

- A joint five-state/FCC audit of Southwestern Bell affiliate transactions and cost allocations among Southwestern Bell's operating company and its affiliates revealed overcharges by the affiliates totalling $93.7 million for the period 1989-92, which have burdened Southwestern Bell's intra- and interstate ratepayers.[83/]

MCI believes, as it did at the time of the Computer III Remand proceeding, that cost allocation rules are inherently ineffective, no matter how many bells and whistles are added to the process. As MCI explained in its Comments in that docket, such rules cannot work because: there is no accurate method for developing an allocator for jointly used resources; LEC control over allocation formulae and the internal data used to populate the formulae result in the distorted apportionment of costs; and BOCs will continue to overproject their regulated use of joint investment and expenses, rendering any forward-based allocation incorrect.[84/] Cost accounting rules also do not work because

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[82/] Consent Decree Order, The GTE Telephone Operating Companies, AAD 94-35 (released April 8, 1994).

[83/] Five States Regulatory Commissions and Federal Communications Commission Joint Audit Team, Review of Affiliate Transactions at Southwestern Bell Telephone Company (May 1994), attached as Appendix to MCI's ex parte submission.

[84/] The lack of any real control over such projections is epitomized by the Commission's laughably limp warning to the LECs in the Video Dialtone Order that it "would not anticipate accepting a 0% allocation of overhead" to video dialtone service (continued...)

there is no effective deterrent to violations. If and when a violation happens to be uncovered by an audit years later, the competitive and ratepayer injuries have long since occurred, and, after a refund is ordered, the BOC is no worse off than if it had never violated the rules. The relevant portion of MCI's prior Comments explaining these points in more detail is attached hereto as Exhibit C.

In the Computer III Remand Order, 6 FCC Rcd at 7596-97, ¶¶ 55-56, as well as in other proceedings addressing cost allocation rules in various contexts,[85] the Commission has presented price cap regulation as the magic bullet that will suppress the incentives to cross-subsidize to the point where such activities, at least at the interstate level, can be adequately controlled by means of cost allocation rules. As the recent audit findings indicate, however, that has not turned out to be the case. One must assume that the post-price cap cost shifting revealed by these audits was motivated, rather than purely random behavior. It follows that there is still a healthy drive to cross-subsidize among the BOCs even after the advent of price cap regulation. As

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[84](...continued)
in applying the new services test. Memorandum Opinion and Order on Reconsideration and Third Further Notice of Proposed Rulemaking, Telephone Company - Cable Television Cross-Ownership Rules, Sections 63.54-63.58 and Amendements of Parts 32, 36, 61, 64 and 69 of the Commission's Rules to Establish and Implement Regulatory Procedures for Video Dialtone Service, CC Docket No. 87-266, FCC 94-269 (released Nov. 7, 1994) at ¶ 229.

[85] See, e.g. [Video Dialtone Orders].

MCI and other parties have explained for years, the sharing obligation and other rate-of-return aspects of price cap regulation create more than a sufficient incentive to continue cross subsidizing. Moreover, price cap regulation of interstate rates cannot have any impact on intrastate cross-subsidies, which are probably more significant for most ESPs.

Because the BOCs' incentives to inflate regulated costs continue, price cap regulation has not been the panacea for interstate cross subsidization that was once envisioned. The Commission therefore cannot rely on price cap regulation to supplement its cost separation rules. Moreover, the latter cannot be relied upon to substitute for structural separation, for the reasons explained in MCI's previous Comments and as evidenced by the recent audit findings.[86] Not only do those audits demonstrate that this Commission's system of price cap regulation has not diminished the BOCs' incentives to cross-subsidize at the interstate level (and could not have any impact on intrastate cross-subsidies), but they also demonstrate the BOCs' undiminished ability to do so.

All objective analyses concur that even with price cap regulation, the Commission's cost allocation oversight burden has

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[86] It is also no answer that the audits themselves prove the effectiveness of the cost accounting rules. All of these audits have taken place long after the fact, after the damage has been done to competition and to ratepayers. Structural separation operates before the fact, preventing the injury altogether.

grown, and "the staff resources allocated to this function have declined rather than increased ... [and] the number of FCC auditors remains inadequate to provide a positive assurance that ratepayers are protected from cross-subsidization."[87/] As the House Judiciary Committee noted:

> Some have asserted that the current regulatory scheme limits the potential for anticompetitive conduct because of regulations such as price caps, automated reporting, non-discrimination reports, and State safeguards. To a large extent, the value of regulatory oversight depends upon enforcement resources which, as noted above, do not presently exist. The regulatory problem is exacerbated with regard to the RBOCs because they dominate entire geographic regions and overlap Federal and State regulatory jurisdictions. See, e.g., National Ass'n. of Regulatory Util. Comm'rs. Some RBOCs Are Not Cooperating With the NARUC's Joint State/Federal Audit Efforts (NARUC Summer Meeting, July 28, 1992) (detailing difficulties in coordinating overlapping State and Federal audits of the RBOCs.) In addition, it is widely understood that regulations are incapable of preventing anticompetitive conduct by monopoly utilities because of the inherent difficulty for regulators to second-guess a utility's subjective engineering and procurement judgment. See, e.g., 3 Phillip Areeda & Donald Turner, Antitrust Laws § 726, p. 219 (1978), ("the integrated utility can always argue that its product, though more expensive, is 'better'").[88/]

Given the evident weaknesses of cost allocation rules as a safeguard against cross-subsidies, after so many years of tinkering by the Commission, it would be irrational to eliminate the structural separation requirement. That rule eliminates most

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[87/] U.S. General Accounting Office, Telecommunications - FCC's Oversight Efforts to Control Cross-Subsidization, GAO/RCED-93-34, at 12 (Feb. 1993).

[88/] Antitrust and Communications Report at 59 n.246.

of the problems of cross-subsidization by eliminating most joint and common costs and the opportunities for arbitrary misallocation of those costs. Structural separation also highlights transactions between affiliates, thereby inhibiting cost shifting. Structural separation also provides state commissions with a powerful tool to control intrastate cross-subsidies, an especially difficult task when dealing with multi-state RBOCs. Given the Commission's chronically inadequate auditing and enforcement resources, the largely self-enforcing structural separation requirement is the only realistic safeguard against cross-subsidies.

CONCLUSION

It is clear that the case for eliminating structural separation is far weaker now than it was at the time of the Computer II Remand proceeding, just as it was for weaker then than it had been at the tme of the original Computer III proceeding. ONA has now been held twice -- in California II and California III -- to constitute a significant retreat from the Commission's original promise of a fundamental unbundling, and thus an opening up, of the BOC network. As the Hatfield Report explains, the advanced technologies that were supposed to facilitate such unbundling are instead being used by the BOCs to tighten their grip on the local exchange bottleneck and close off access to competitive service providers. The paralysis of ONA leaves CEI and the other antidiscrimination rules as the main